## NATIONAL FORECAST DESCRIPTION
### The Forecast Period is the Third Quarter of 2000 to the Fourth Quarter of 2004

The U.S. economy is expected to slow this year, after posting an impressive gain in 2000. This outlook was stronger than had been expected last January. In the previous forecast, real GDP was projected to rise a healthy 3.4%. It is currently predicted that real GDP will grow a robust 5.3% in 2000, well above all but the most optimistic estimates of its potential. Interestingly, the previous forecast predicted the economy would slow during the first half of 2000 before rebounding in its second half. History has proven the opposite to be true. Real GDP surged during the first half of last year, but has slowed noticeably in recent months. For example, real GDP grew at a 4.8% annual pace in the first quarter of this year, and by less than half that rate (2.2%) in the third quarter. Thus, instead of strengthening, the economy is weakening during the second half of the year.

After years of clear skies, the current forecast calls for a cloudier outlook. DRI has identified four factors that could complicate the economy's journey over the short term. The first factor is high energy costs. Oil prices have nearly tripled from their early-1999 level. In the event of a severe winter or supply disruption, prices could go even higher. This could have significant repercussions. All three of the last recessions were due to troubles in the Middle East and rising oil prices. In addition, natural gas prices are also jumping. Nevertheless, a case for guarded optimism can be made. First, the inflation-adjusted price of oil is not dangerously high. Second, the U.S. economy is less dependent on oil than it used to be. Third, higher prices should boost exploration, which will eventually lead to increased energy supplies.

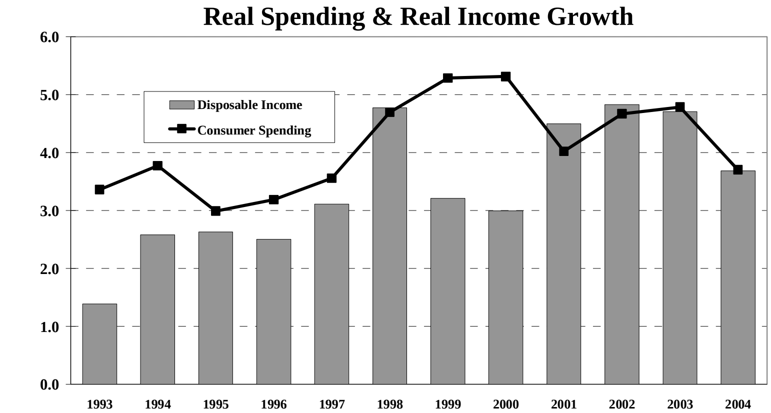
Despite the stock market's recent dive, it still remains overvalued and could be subject to further correction. The price/earnings ratio for the U.S. stock market stands near 23. Based on current earning estimates, the forward price/earnings ratio should be about 18, suggesting the market is still overvalued. Not surprisingly, all of this excess is concentrated in the high-tech sector. Its price to equity ratio was recently estimated at 34, far higher than any other major sector in the market. The good news is that except for technology, the rest of the market seems fairly valued.

The impact of the falling stock market on consumption is not a trivial question. Consumer spending has played an important role in the current expansion, and it has benefited from swelling finance portfolios. Over the last few years, American households have seen their ratio of assets to income rise above six, which is well above the more typical four to five. This was interpreted as the stock market doing the savings for households. This redirected funds to spending, causing the personal saving rate to plunge. The wealth effect also contributed to spending. However, it still is not clear how falling asset values will impact consumer spending. It is likely that this will induce more thrift on the part of consumers, but the actual degree of restraint remains to be seen.

While everyone watched in awe at the shrinking federal budget deficit, it seems that no one noticed the ballooning U.S. trade deficit. It is estimated that in 2000 the U.S. trade deficit averaged $426.4 billion, an increase from 1999's $331.5 billion. It should be noted that the United State's largest trade deficit is with Asia, mostly Japan and China. The reason for this country's trade position with Japan is clear. Exports to Japan have been limited by that country's poor economic health, while imports from Japan have risen as it tries to export its way back to prosperity. The United State's trade deficit with China is actually larger than its deficit with Japan. In the short run, these deficits do not present a problem. But in the long run, they will become increasingly hard to finance.

The current forecast assumes the economy will successfully clear these hurdles. That is, the economy should slow, but it will not stall or retreat over the forecast period.

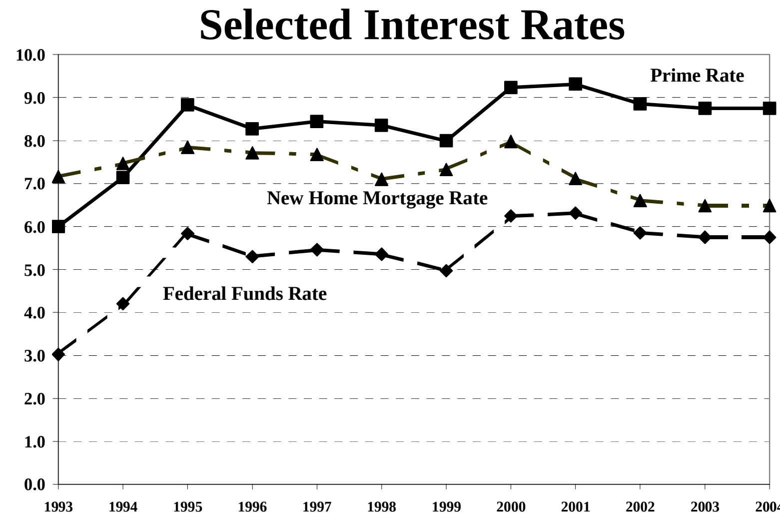
## SELECTED NATIONAL ECONOMIC INDICATORS



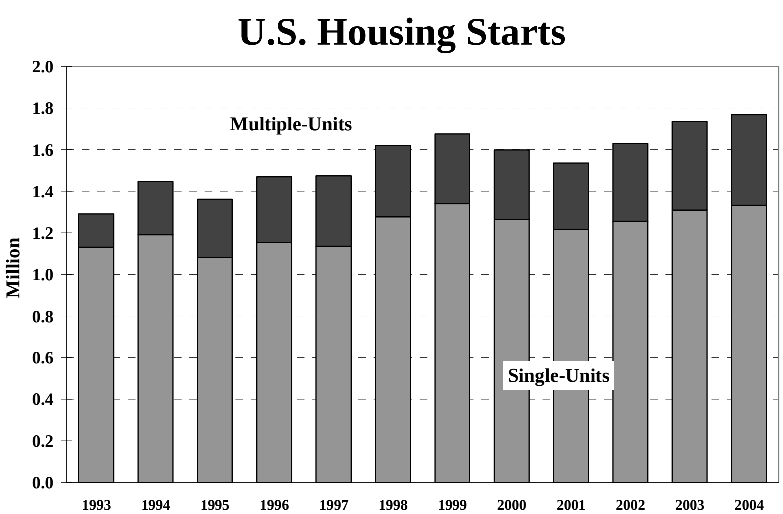
Source: Standard and Poor's DRI

**Consumer Spending:** It appears the high-flying consumer sector is poised to return to earth. Boosted by growing confidence, real consumer spending surged at seemingly unsustainable levels during most of the 1990s. Generally, it would be expected that in the long run real consumer spending would expand no faster than real disposable income. However, in the eight-year period containing the years 1993 to 2000, real consumer spending exceeded real disposable income growth in all but one year. Growth in the initial years reflected the usual recovery from an economic slowdown. During the 1990-91 recession, real spending contracted as consumers put off making large purchases until they were confident the economy was once again expanding. Spending on these deferred purchases accounted for a large portion of the increase in consumer expenditures. However, spending did not taper off once this pent-up demand was satisfied. The tightest job market in a generation, a strong stock market, and low inflation fueled consumer confidence levels that kept consumers spending above their means. Consumers increasingly turned to debt and savings in order to keep spending faster than income was growing. From 1992 to 2000, outstanding consumer credit (not including mortgage or lease payments) increased an average of 8.5% per year, nearly doubling from $782.2 billion to $1.5 trillion. Looked at another way, the ratio of outstanding credit to disposable income rose from 16.5% in 1992 to 21.4% in 2000. American households have also used savings to finance their collective spending spree. Specifically, the U.S. personal savings rate dropped from nearly 9.0% in 1992 to virtually zero in 2000. In fact, in the summer of 2000, the personal savings rate turned negative. In all fairness, the savings rate slide is not solely caused by spendthrift consumers. To the chagrin of financial planners, Americans are not regular savers. Instead, Americans need a reason to set aside money. They save for a college education for their children or a down payment for a house. Once the target is met, saving stops. Another reason for the dismal savings is that Americans are richer. Over the last few years, the soaring stock market has raised wealth to over six times income. This is well in excess of the 4-5 times wealth-to-income ratio that held from the 1960s through the first half of the 1990s. Higher wealth also helps consumption because it is estimated that for every additional $100 wealth, $2.50 is spent. Unfortunately, the years of 20%-plus stock market gains appear to be behind us, and this, compounded with already high debt loads and a loosening job market, should cause consumer confidence to drop and real consumer spending to slow. Already, weaknesses are starting to appear. For example, consumer confidence fell for three consecutive months in late 2000. Credit levels have risen more slowly in recent months, as consumers have resisted purchasing big-ticket items. Automobile purchases have been particularly hard hit despite heavy discounting. As other factors play less of a role in propping up spending, real disposable income growth should once again set its upper limit. This being the case, it is important to note real disposable income should advance 3.0% in 2000, 4.5% in 2001, 4.8% in 2002, 4.7% in 2003, and 3.7% in 2004. Real consumer spending is expected to rise 5.3% in 2000, 4.0% in 2001, 4.7% in 2002, 4.8% in 2003, and 3.7% in 2004.

**Financial:** The Federal Reserve is done tightening for this business cycle. The last time the nation's central bank raised its federal funds rate target was in May 2000. The third quarter 2000 economic slowing suggests that the monetary brakes are working. The timing is right on schedule; the first rate hike was in June 1999, and the cooling down commenced a year later. The next Federal Reserve move is likely to be downward, but not until later this year. The inflation wary Federal Reserve would like to keep interest rates stable until it is convinced that the need to tighten is over, and there is good reason to loosen. The central bank may also want to wait until President Bush's economic plans are clearer, since fiscal stimulus may require higher interest rates. It should be noted that low inflation has been one of the Federal Reserve's strongest allies recently. Real interest rates are the highest they have been since 1989, not because nominal interest rates are high, but because inflation has been so low. It is also worth mentioning that the Federal Reserve remains zealous in its fight against inflation. If core inflation begins to take off, the Federal Reserve will likely slam on the monetary brakes. In other financial news, it appears that the stock market remains overvalued, but not by as much as it was at the beginning of 2000. Most of this overvaluation can be traced to technology stocks. For example, the price/earning ratio for technology companies was around 36 late last year. In comparison, the price/earning ratio for non-technology stocks was under 20, which seemed to be in line with fundamentals. The current outlook calls for the stock market to advance by less than 10% annually over the next five years.




Source: Standard and Poor's DRI

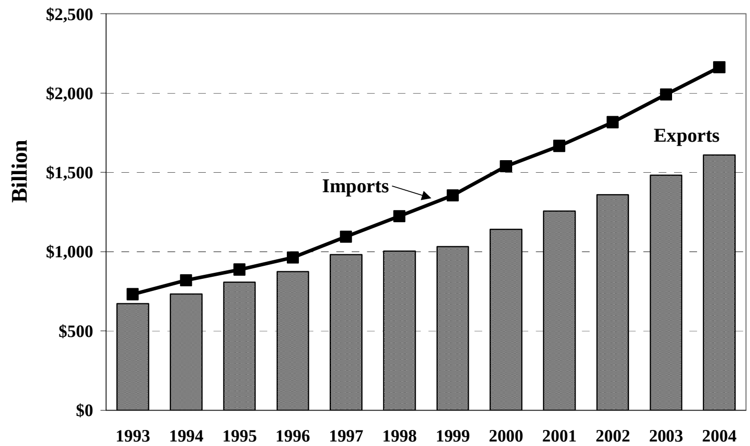



Source: Standard and Poor's DRI

**Housing:** A review of several housing industry indicators fails to present a clear picture for the future. This represents a change from the recent past when key factors pointed toward sustained, strong growth. This is not to say the outlook has weakened, it is just harder to determine. For example, a recent Fannie Mae report shows a 20-percentage-point decline in the number of persons considering it a good time to buy a home compared to last year. Other evidence supports these findings. The University of Michigan survey of consumer sentiment recorded a five-percentage-point decline in the number of respondents with favorable home-buying attitudes during October 2000 and an eight-percentage-point increase in the number of households that thought home prices were high enough to delay purchases. This should raise some warning flags because housing is usually one of the first victims in an economic slowdown. On the other hand, not all the news is bad. In the Fannie Mae survey, nearly one in four respondents said they still plan to buy homes in the next three years. Perhaps these households have concerns about the overall economy, but feel comfortable with their own financial situations. Perhaps falling interest rates are too tempting to resist. The interest rate on an average 30-year mortgage peaked at 8.6% in May 2000, but dropped below 8.0% this fall. Indeed, the housing industry seemed healthy last fall. In September 2000, new home sales grew at a 9.2% annual rate and existing home sales remained strong. The current forecast calls for a finely tuned slowdown in the housing industry. This year, home sales should drift into the 5.8-6.0 million-unit range. Housing starts are expected to slip from 1.6 million units in 2000 to 1.5 million units in 2001. However, this industry should recover quickly. Specifically, U.S. housing starts should climb from 1.5 million units in 2001, to 1.6 million units in 2002, to 1.7 million units in 2003, and to 1.8 million units in 2004.

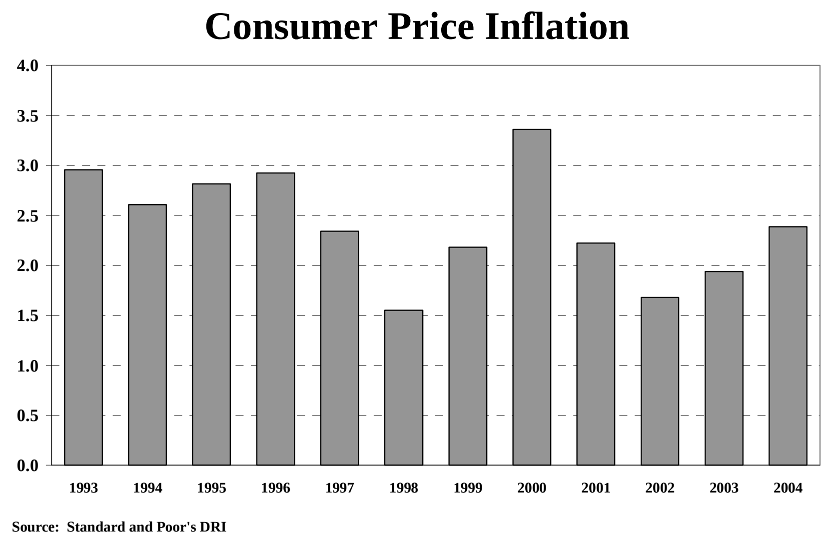
**International:** In the late 1990s the so-called twin deficits, trade and federal budget, hit a fork in the road and went their separate ways. Both expanded relentlessly since the 1980s. However, thanks in large part to fast rising federal revenues caused by the booming national economy, the unified federal budget deficit began shrinking in federal fiscal year 1993, and it has been in surplus since fiscal year 1998. On the other hand, the record-long U.S. economic expansion has contributed to a deepening of the nation's trade deficit. Since achieving a rare surplus in 1991, the U.S. current account deficit has swelled to $426.4 billion in 2000. The current forecast calls for this deficit to grow even larger over the next few years, reaching nearly $600 billion in 2004. This outlook reflects the U.S. continued economic strength compared to some of the world's larger economies. For example, the U.S. real GDP growth is anticipated to average 4.3% per year over the 2002-2004 period. This will benefit our NAFTA partners. Canada, which has grown slightly slower than the U.S., is expected to continue this trend into the near future, with its real GDP advancing about 3.7% annually. Mexico's economy has grown faster than the U.S. economy, and should continue to do so through 2004. Mexico's economy is showing good health. It is benefiting from the strong demand from the U.S. At the same time, inflation continues to decline and real wages have climbed. The forecast for Japan is not as rosy. Although, the world's second largest economy has shown intermittent signs of life, a sustained recovery has remained elusive. Federal spending has proven to be a short-lived stimulant, but a longer term relief from this country's economic doldrums will only come when it gets its economic house in order. Huge amounts of capital remain locked in unproductive enterprises. Not all the news from the Pacific region is bad. Indeed, except for Japan, most of the economies are recovering nicely from the Asian economic crisis. Middle-income Asian nation economies rose 5.8% in 1999 and 6.9% in 2000. They are expected to average 6.3% real growth from 2002 to 2004. Unfortunately, this growth could be threatened by government meddling. For example, the South Korean government has strong-armed banks into keeping insolvent companies afloat in order to stem rising unemployment. This policy will lock up valuable capital in nonproductive enterprises. The economic forecast for the large western European economies—France, Germany, Italy, and the United Kingdom—calls for growth of 2.5%. A major concern is to what extent rising oil prices will sabotage economic growth. The impact varies between the industrialized and non-industrialized countries. It is estimated that oil prices in the $30-$35/barrel range will subtract 0.25-0.50 percentage points from GDP growth in the industrialized countries. It exacts a higher toll on developing countries because they are more dependent on oil. For example, it is estimated that a $5/barrel increase in the price of oil will reduce GDP growth in Bulgaria, South Korea, and Hungary between 1-2 percentage points.

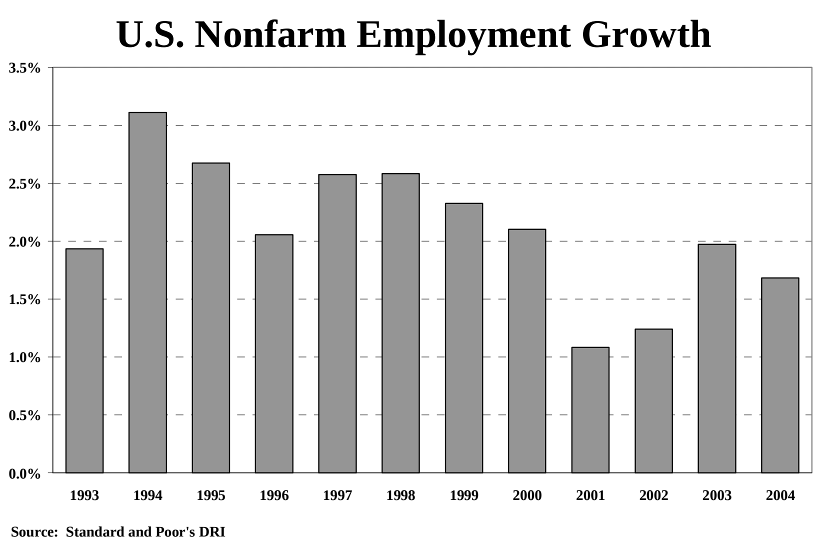
**Real U.S. Imports and Exports**




Source: Standard & Poor's DRI

**Inflation:** Recent evidence suggests that inflationary pressures are receding, which implies the threat of higher inflation is behind us. Two areas that were particularly worrisome, labor costs and import prices, appear to be cooling. Labor costs are a major determinant of core inflation. Given the tightness of the labor market, there have been concerns that these costs could spiral upwards, dragging along the core inflation rate for the ride. However, current data indicates that the employment situation may be easing and employment costs remain relatively well behaved. The U.S. Department of Labor reported that total nonfarm employment rose by just 94,000 from October 2000 to November 2000. And though the civilian unemployment rate held at 4.0%, both the number of private hours worked and overtime hours worked fell over this period. Other data shows that in the fall of 2000, both hourly wages and the employment cost index were growing at a 4.0% annual rate. Fortunately, productivity growth has been able to offset these gains, and help keep unit labor costs manageable. The acceleration in import prices in early 2000 was a major concern. This is because low import prices have kept domestic producers from raising their prices in order to remain competitive. If import prices continued to rise, then the U.S. would lose an important check against higher domestic inflation. This does not seem to be the case. In October 2000, import prices declined, as oil prices retreated. But looking past energy prices, import prices actually fell in September and were unchanged in October. On a year-over-year basis, non-petroleum import prices were up just 1% in October 2000. Admittedly, oil prices remain stubbornly high. However, they remain relatively stable. In spite of this, energy price inflation will be a major burden for households and businesses this year. Even before the first major winter storm hit, the public has been put on notice that natural gas and heating oil prices could explode. It is estimated that the price of natural gas rose at a 27.9% annual rate in the second quarter of last year, followed by a 50.1% increase in the third quarter, and an 18.8% rise in the last quarter. The price for fuel oil and coal jumped by a whopping 23.5% annual rate in the second quarter of 2000, but has eased slightly since then. It is believed the earliest relief will come from these runaway increases is in the spring of 2001.




**Employment:** The tightest labor market in a generation is beginning to show signs of loosening up. Since April 2000, initial claims for unemployment insurance have been creeping up. Another sign that the labor market is starting to slacken is the duration of unemployment has remained fairly stable. One would expect the average length of time an employee would be out of work would decrease as the supply of excess labor disappeared. Although the average duration is still falling, the median duration held close to six weeks in 2000. In addition, the proportion of workers unemployed five weeks or less was stable at 45%, after rising steadily for 3 years. Also, the share of unemployed who lost rather than left jobs has begun to rise. The average workweek has slipped below the 34.5-hour average of 1999. Finally, the U.S. unemployment rate has budged from 3.9% in October 2000 to 4.0% in November 2000. Despite, the factors described above, it is important to remember that the labor market remains tight. Even at 4.0%, it is still 1 to 1 1/2 percentage points below most estimates of full employment. Naturally, such a tight labor market leads to worries about wage-push inflation. Wage-push inflation occurs when employers must bid up wages in order to attract relatively scarce labor. Eventually, these higher wages put upward pressures on consumer prices. So far, this has not been a problem. Although the 3.8% year-over-year jump in average hourly earnings during October 2000 was the largest in nearly two years, productivity increases were sufficiently large to cover most of this increase. <u>Nonfarm employment growth is projected to slow over the next two years, then post a slight rally.</u> <u>Over the forecast period, the U.S. civilian unemployment rate is expected to be 4.0% in 2000, 4.4% in 2001, 4.6% in 2002, 4.2% in 2003, and 4.0% in 2004.</u>